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Background Study

CANADA-U.S. FREE TRADE: THE EXCHANGE RATE AND EMPLOYMENT POLICY

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Ministry of Treasury and Economics
Government of Ontario
May 1986

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UNIVERSITY OF CALIFORNIA
SAN DIEGO

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Introduction

The purpose of this short study is to outline why the exchange rate will be a factor in bilateral trade negotiations between Canada and the United States. The only issue, and it is a semantic one, is at which table the exchange rate will formally be discussed. It now appears that the new Group of Seven (G-7) will be the official forum.

However, whatever the forum, and whatever agency of the U.S. Administration is in charge[1], the exchange rate and trade policy issues will be joined in the Congress. The Congress will be the ultimate arbiter of any trade agreement with Canada. If the Administration is to achieve its trade policy goals, it must recognize this authority. Indeed, the Treasury Secretary, James Baker, who is responsible for international monetary relations, is reported to have said, "...nobody wants to sell out our free-trade policy....But we've got to be sure we can sustain the president's veto....to do that, we're going to have to do some things; we're going to have to recognize the political problem with the Congress."[2]

The link between exchange rates and trade policy can be seen in U.S. Congressional attitudes and, more recently, in Administration policy. Current protectionist pressures in the Congress are closely related to the U.S. trade deficit. The trade deficit, in turn, has been attributed largely to an overvalued U.S. dollar. Accordingly, some members of Congress believe that America's trading partners should realign their currencies to reduce the competitive disadvantage to American industries. The Administration, aware of these views, and in an apparent attempt to alleviate protectionist pressures, engineered the Group of Five (G-5) agreement of September 1985 to work toward lowering the value of the American dollar.

Exchange Rates and Protectionism

The U.S. merchandise trade deficit rose from $36 billion (U.S.) in 1982 to $122 billion (U.S.) in 1985. One of the major factors behind the increase was the appreciation of the dollar between 1980 and 1985. The Congressional Research Service estimates that one-half to three-

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1 The U.S. Trade Representative, Clayton Yuetter, is in charge of negotiating trade policy, while the Treasury Secretary, James Baker, has responsibility for international monetary relations. Secretary Baker also chairs the cabinet-level committee responsible for overall economic policy strategy, of which Trade Representative Yuetter is a member.

2 *Wall Street Journal*, April 17, 1986.

quarters of the U.S. trade deficit reflects the 76 per cent increase in the trade-weighted value of the U.S. dollar between July 1980 and December 1984.[3] A recent study suggests that, at the end of 1984, the U.S. dollar was overvalued by 24 per cent against the yen, 50 per cent against the Deutschmark, 44 per cent against the French franc and 25 per cent against sterling.[4]

The deteriorating trade position of the United States has been a major cause of the recent slowdown in the American economy. Moreover, it has contributed to significant job loss in the U.S. industrial sector. For example, in April 1986 there were 242,000 fewer factory jobs in the U.S. than in January 1985. The machinery industry lost 120,000 jobs and the electrical products industry 71,000 jobs over this period. These job losses have spurred demands for strong action on U.S. trade and international monetary policy.

Historically, an overvalued American dollar has been associated with increasing protectionism in the United States. In the late 1960s and early 1970s, an overvalued dollar triggered increased protectionist sentiment, despite relatively modest levels of unemployment. The subsequent interventions in exchange markets, and the currency depreciations of 1971 and 1973, relieved the pressure and facilitated the passage of the Trade Act of 1974, authorizing trade liberalization through multilateral negotiations.

During 1975-76, the U.S. dollar again became overvalued. This resulted in renewed protectionist pressure and the adoption of several new restrictive trade measures, including the trigger price mechanism for steel and trade barriers for sugar and shoes. The subsequent depreciation in 1978-79 supported a dramatic improvement in the U.S. trade position. This once again led to Congressional support for both the Trade Act of 1979 and the Tokyo Round of tariff reductions.[5]

In recent years, the mounting trade deficit has resulted in what has been referred to as the most protectionist U.S. Congress since the passage of the Smoot-Hawley Tariff Act of 1930. At present there are over 300 protectionist bills before Congress. While many of these bills are little more than statements of concern, support is growing for the

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3 G. Holliday et al., *Trade Legislation in the 99th Congress: A Comparison of Selected Proposals to Reform U.S. Trade Laws*, Congressional Research Service, Washington, 1986.

4 John Williamson, *The Exchange Rate System*, Institute for International Economics, 1985.

5 U.S. exchange rates and protectionism are discussed in C. Fred Bergsten and John Williamson, "Exchange Rates and Trade Policy", *Trade Policy in the 1980s*, edited by William R. Cline, Institute for International Economics, 1983.

passage of a comprehensive trade bill. Many of the omnibus trade bills have included provisions for negotiating exchange rates.

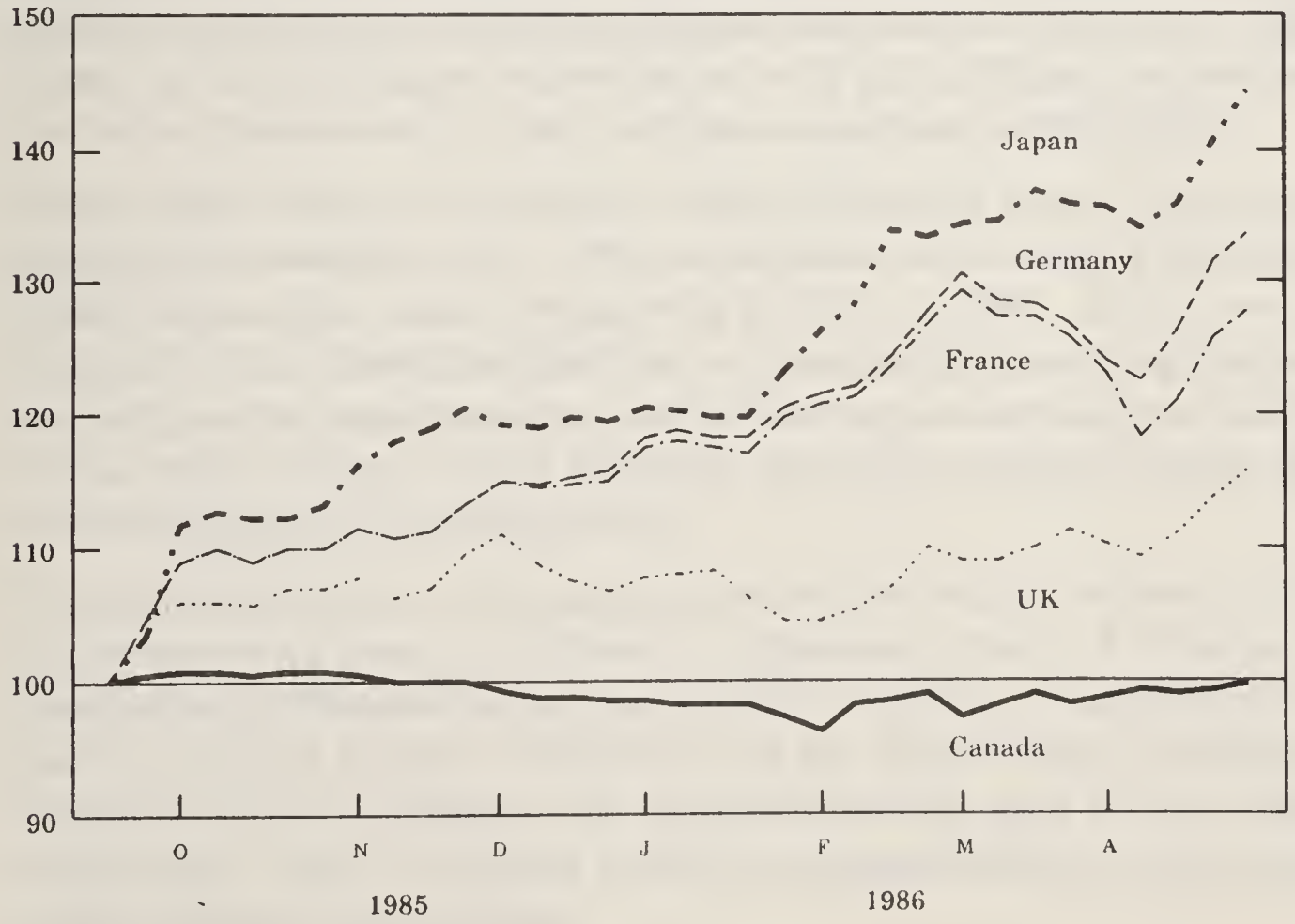
A New Approach: The G-5

Until recently, the Reagan Administration had rejected intervention in currency markets. The Administration regarded the U.S. dollar's strength as an unambiguous indication of the vigour of the American economy. However, in September 1985, the Administration reached an agreement with the other Group of Five industrial nations. The main objective of this agreement was to lower the value of the American dollar relative to the other G-5 currencies. This change in attitude by the Administration was both an acknowledgement of the consequences of the overvalued dollar and an attempt to reduce protectionist pressures in the Congress. In this way, exchange rates have become a central factor in American trade strategy.

The result of the G-5 agreement has been dramatic. Since the agreement was reached in September 1985, the U.S. currency has declined by roughly 30 per cent against the yen, 23 per cent against the German mark, 12 per cent against sterling and 20 per cent against the French franc. However, despite considerable volatility in the

U.S. DOLLAR EXCHANGE RATES OF MAJOR CURRENCIES

(September 18, 1985 to April 30, 1986)



Note: Index Basis, September 18, 1985 = 100
Source: Bank of Canada and Ontario Ministry of Treasury and Economics.

intervening period, the Canada-U.S. exchange rate was the same at the end of April as it was immediately prior to the G-5 accord.

Potential Pressure on Canada

Despite the recent exchange rate revaluations, improvement of the U.S. trade position is likely to be sluggish. Although Japan and the three European nations in the G-5 figure prominently, they account for only 48 per cent of the politically sensitive U.S. merchandise trade deficit. Latin American, Asian and African countries account for 37 per cent. Many of these countries, burdened with debt, are unlikely to be able to increase appreciably their imports or reduce their exports. Accordingly, pressures for protectionist measures or further exchange rate realignment are likely to persist.

Both West German and Japanese authorities have already expressed concern about the extent of the appreciation of their currencies against the American dollar. In this context, Canada might be expected by Japan and the European members of the G-5 to help reduce U.S. pressure against them.

The formal mechanism for exerting this pressure could be through the new Group of Seven. The G-7 is an attempt to coordinate international monetary and fiscal policies to sustain the current expansion of the industrialized economies. The idea is for each country to pursue expansionary policies according to some independent assessment of its ability to do so and its own domestic and international objectives. The intent is that "enhanced surveillance" will put political pressure on individual members to go along with the overall needs of the group.

From 1980 to 1985, the Canadian dollar declined by about 15 per cent against the American dollar. This contributed to Canada's $20 billion (Cdn) merchandise trade surplus with the U.S. in 1985. At the recent Senate Finance Committee hearings on granting fast-track negotiating authority to the Administration, and at hearings concerning the results of the Tokyo Summit, some Senators expressed concerns about the current Canada-U.S. exchange rate.

U.S. industry is also urging the government to include exchange rate negotiations as part of a bilateral agreement. The U.S. National Association of Manufacturers, for example, recently recommended to both the Senate Finance Committee and the House Ways and Means Committee that exchange rate consultations be part of the trade negotiations. The U.S. lumber lobby has expressed similar views to the Administration and Congress.

A precedent exists for the U.S. demanding a Canadian dollar appreciation, although on that occasion Canada rejected the U.S. demand. In August 1971, the U.S. asked Canada to fix the value of its dollar at a higher level.[6] According to Ambassador Simon Reisman, the Americans issued "threats at the Smithsonian meetings later that year to terminate the automotive agreement if Canada refused to conform to U.S. ideas as to what an appropriate exchange rate policy for Canada might be".[7]

Impact of Exchange Rate Appreciation

The short-run macroeconomic effects of a policy decision to change the value of the Canadian dollar are significant. As an illustration, Table 1 presents the broad impacts on the Canadian economy of a 5 cent increase in the Canada-U.S. exchange rate. Employment falls by 56,000, while the unemployment rate increases by 0.4 percentage points in the first year.

In this simulation, it was assumed that, without changing Canadian monetary policy, foreign authorities would agree to intervene in foreign exchange markets to purchase Canadian dollars. The adverse effects in this case do not incorporate any impacts of higher Canadian interest rates that would likely be necessary to support the Canadian dollar at the higher value.

Simulation I: Autonomous Appreciation — Table 1

	Short-Run Impact
Real GNP (%)	–0.5
Employment	–56,000
Unemployment Rate (percentage points)	+0.4

Source: Ontario Ministry of Treasury and Economics.

Note: The results were derived by performing a simulation on an econometric model of the Canadian economy in which the value of the Canadian currency was raised by 5 cents. The short-run refers to changes in the first year. See Appendix A.

Table 2 shows the impact on the Canadian economy of an appreciation of the Canadian dollar brought about by increasing the Canada-U.S. interest rate spread sufficiently to raise the Canada-U.S. exchange rate

6 Stephen Clarkson, *Canada and the Reagan Challenge: Crisis and Adjustment, 1981-1985*, James Lorimer and Co., 1985.

7 E.R. Fried and P.H. Trezise (eds.), *U.S.-Canadian Economic Relations: Next Steps?*, The Brookings Institution, 1984.

by 5 cents. At the new exchange rate, annual employment is 140,000 lower, while the unemployment rate increases by 0.9 percentage points.

Simulation II: Appreciation by Higher Interest Rates — Table 2

	Short-Run Impact
Real GNP (%)	–1.0
Employment	–140,000
Unemployment Rate (percentage points)	+0.9

Source: Ontario Ministry of Treasury and Economics.

Note: The results were derived by performing a simulation on an econometric model of the Canadian economy. In the simulation, the currency was raised 5 cents U.S. by raising short-term interest rates in Canada to stand roughly 500 basis points above the base case after four quarters. They were then maintained at that relative level. The short-run impact refers to the changes in the first full year at the new exchange rate. See Appendix A.

The appreciation of the Canadian dollar could also be brought about if the Bank of Canada held domestic interest rates fixed while U.S. rates declined. However, the magnitude of impacts would be slightly different.

These results are similar in magnitude to those obtained in other simulations.[8] Since a combination of approaches is likely to be used, the two sets of results might be thought of as representing the lower and upper bounds of an actual attempt to raise the value of the Canadian dollar.

Policy Freedom: The Short and Longer Terms

The possibility explored in the previous section is that Canada could be encouraged to raise the exchange value of its currency. However, this is not necessarily the precise manner in which Canadian policy may be constrained. There are other scenarios. For example, were domestic economic activity to turn down in late 1987 or 1988, a more stimulative Canadian monetary policy would be appropriate. If this action resulted in a decline in Canadian interest rates relative to those in the U.S., then the value of the Canadian dollar might fall further. It is possible that the U.S. could choose to interpret this as a competitive

8 A Bank of Canada study *(Seminar on Responses of Various Models to Selected Policy Shocks*, Ottawa, 1982) reported the effects of currency depreciation on the Canadian economy. See Appendix B.

depreciation, which might then jeopardize the prospects for Congressional acceptance of a bilateral trade agreement. To avoid this, Canadian monetary policy might be prevented from supporting growth in the Canadian economy. This could happen even in the absence of an explicit American request to raise the value of the dollar.

The potential loss of control over monetary policy is particularly serious in light of the commitment of the federal government to deficit reduction. With fiscal policy constrained by the priority assigned to cutting the federal deficit, monetary policy is the sole lever of Canadian stabilization policy. Sacrificing control over the money supply and interest rates would deprive the federal government of any levers with which to stabilize the aggregate level of economic activity.

Over a longer period, the operation of a Canada-U.S. free trade arrangement could lead to the establishment of "fixed" or formally "managed" rates of exchange between the two countries. The reason is that exchange depreciations are sometimes seen as a beggar-thy-neighbour policy, just as much as other forms of trade policy intervention. Therefore, it is often argued that good international trade relations require countries to forego this method of adjustment. If this were to happen, then Canada would no longer be free to pursue, even in principle, an independent monetary or interest rate policy. The central objective of monetary policy would be the maintenance of the "fixed" or "managed" rate of exchange, without regard to domestic employment conditions.

In this regard, there have been clear advantages to a policy of flexible exchange rates for Canada.[9] In recent years, currency depreciation has facilitated adjustment, first to higher inflation and then to sharp declines in commodity prices and sales volumes. More generally, depreciation of the currency can mitigate the adverse domestic employment effects of adjustment to international payment deficits. Such deficits can be corrected without severe deflation of the domestic economy.

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9 A recent study documents how "a floating exchange rate can effectively insulate the real side of the Canadian economy from U.S.-based shocks". Andre Plourde, *The Impact on Canada of Changes in U.S. Economic Performance: Estimates from the FOCUS Model*, Institute for Policy Analysis, University of Toronto, 1985..

Conclusion

Exchange rates, protectionism and trade policy are all linked in the politics of the Congress. This link led the U.S. Administration to negotiate the September 1985 agreement of the G-5, reducing sharply the value of the American dollar. The G-5 has recently been expanded to include Canada and Italy. One of the issues to be discussed in this new group is exchange rates between member countries. The Canada-U.S. exchange rate already has been raised as an issue in the Congress. Since Congress has ultimate authority to approve a Canada-U.S. bilateral trade agreement, exchange rates and trade policy will inevitably be linked in the short-run. The long-run result could be a more formally managed exchange rate system.

Appendix A

Simulation Experiments on the Impacts of a Currency Appreciation on the Canadian Economy

To get a quantitative assessment of the short-run impact of exchange rate changes, simulation experiments were performed on an econometric model of the Canadian economy.[1] There are several caveats to this exercise:

- The magnitude of the exchange rate change is merely illustrative.
- Different models will yield different results, although the direction of change should typically be the same. This issue is addressed in Appendix B.
- Simulations, even on the same model, can be performed using slightly different assumptions. Differing assumptions may yield differing magnitudes in the results.

Two separate experiments were performed and the results compared to a base case forecast of the Canadian economy.

The key exchange rate variable in the model is the noon spot rate. It is determined primarily by Canada/U.S. interest and inflation rate differentials, the trade balance and capital flows.

Simulation I

For the first simulation, it was assumed that foreign authorities intervened in the market to purchase Canadian dollars. In this simulation, the Canada-U.S. dollar noon spot rate was increased by 5 cents and held there throughout the experiment. This simulation represents the pure exchange rate effect and may be considered the lower bound of the impact of an exchange rate appreciation.

The impact of higher exchange rates affects the economy through two major channels. The largest impact is felt through trade. The higher valued dollar increases the price of Canadian exports, reducing their demand. Imports are now cheaper, and show a significant increase, replacing the production of Canadian-made goods. The combination of reduced exports and increased imports reduces the need for new investment, thereby slowing spending on machinery and equipment and non-residential construction. The combined effects result in reduced employment and lower output, as shown in Table A1.

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1 The model was developed and is owned by Chase Econometrics Canada. It is a standard macroeconomic model of the Canadian economy which mirrors the Statistics Canada National Accounts framework.

Simulation II

In practice, it would be difficult to sustain a 5 cent increase in the Canada-U.S. exchange rate without support from increased interest rate differentials. Accordingly, a second simulation was carried out. This experiment raised the exchange rate by increasing the 90-day prime commercial paper rate over a four quarter period, thereby increasing the Canada/U.S. short-term interest rate differential by an amount sufficient to raise the value of the dollar by 5 cents. This differential was approximately 500 basis points. This simulation may be thought of as an upper bound of the impact of appreciation, since the entire rise in the dollar is obtained through interest rate increases.

The impacts of this approach are, as expected, considerably more severe than in the first experiment. The interest rate increase depresses domestic demand in the interest sensitive sectors: autos, other consumer durables and housing. Investment also is reduced substantially. The impact in the traded goods sector is slightly different from that in the first case. While exports fall in both simulations, imports fall in the second simulation due to the reduction in domestic demand. Table A1 summarizes these results.

Economic Impacts of Appreciation — Table A1
(Per cent difference between base and control)

	Simulation I	Simulation II
GNP	–0.5	–1.0
Consumption	0.5	–0.6
Investment	–0.3	–3.1
Exports	–0.4	–1.1
Imports	1.1	–2.5

Source: Ontario Ministry of Treasury and Economics.

Appendix B

Other Econometric Simulations of Exchange Rate Changes

There are a number of econometric models of the Canadian economy currently in use. At a seminar sponsored by the Bank of Canada, the response of several of these models to various policy shocks, including an exchange rate shock, was presented.[1] The results obtained in the simulations reported in Appendix A are broadly consistent with those attained by the models cited in the Bank of Canada study.

The simulations in the Bank of Canada study were for an exchange rate depreciation, whereas the simulation reported in Appendix A is for an exchange rate appreciation. Although there is a possibility that the exchange rate movement may not have symmetrical impacts, it is reasonable to expect that the magnitudes would be broadly similar, although, of course, opposite in sign. Therefore, without simulating each of these models anew, the Bank of Canada exercise may be used as a rough test of possible results in different models. In any case, the depreciation simulations serve the same purpose of demonstrating the significant impact of exchange rate changes on the Canadian economy.

The exchange rate equations will vary among the different models, based on the view of the modeller, as well as empirical evidence, as to the relative importance of various inputs. Depending on the particular model, any or all of the following variables may affect the exchange rate: the growth of monetary aggregates, growth of reserves, interest rate and inflation rate differentials and both short and long-term international capital flows. Interest rate differentials play a key role in the determination of the exchange rate in the econometric model used in the Treasury simulations.

A further consideration affecting results is the cyclical position of the economy and the composition of aggregate demand at the time that the exchange rate shocks occur. These factors can affect the magnitude but not the direction of the economic impacts. Given the open nature of the Canadian economy, any significant adjustment in the exchange rate will produce non-trivial impacts regardless of prevailing economic conditions in the base period.

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1 Bank of Canada, *Seminar on Responses of Various Models to Selected Policy Shocks*, Ottawa 1982.

Table B1 compares the results of the simulations reported in the Bank of Canada study. The exchange rate experiments involved simulating a permanent 10 per cent depreciation of the Canadian dollar. Two alternative versions of the shock were considered: one with no change in monetary policy and another simulation accompanied by monetary loosening. The first column of the table is comparable to Simulation I in the Treasury experiments, while the second column is comparable to Simulation II.

Results from the Bank of Canada Study: Short-Run Impacts
(per cent change)

Table B1

	No Change in Monetary Policy	Monetary Loosening
Real GNP		
Dept. of Finance	0.2	1.2
Data Resources	0.5	0.6
Institute for Policy Analysis	N/A	2.3
Informetrica	0.7	N/A
Bank of Canada	0.5	N/A
Employment		
Dept. of Finance	0.2	1.5
Data Resources	0.3	0.6
Institute for Policy Analysis	N/A	2.7
Informetrica	0.3	N/A
Bank of Canada	0.3	N/A
Unemployment Rate (percentage points)		
Dept. of Finance	-0.1	-0.8
Data Resources	-0.3	-0.6
Institute for Policy Analysis	N/A	-1.5
Informetrica	-0.3	N/A
Bank of Canada	-0.2	N/A

Source: Bank of Canada and Ontario Ministry of Treasury and Economics.

Notes: The simulation results reported in the study have been adjusted in order to reflect an exchange rate change of a magnitude comparable to the Treasury experiments.

The short run for each simulation is defined as in Tables 1 and 2 in the paper.

Since the Treasury simulations were performed on a quarterly model, this table includes only the results of quarterly model simulations.

Table B2 presents the results of the Treasury simulations, which are broadly consistent with those presented in Table B1.

Ontario Treasury Simulation Results: Short-Run Impacts
(per cent change)

Table B2

	Simulation I	Simulation II
Real GNP	–0.5	–1.0
Employment	–0.5	–1.2
Unemployment Rate (percentage points)	0.4	0.9

Source: Ontario Ministry of Treasury and Economics.

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